East Lothian Council

REPORT TO: Audit and Governance Committee

MEETING DATE: 14 June 2016

BY: Depute Chief Executive – Resources and People Services

SUBJECT: Annual Treasury Management Review 2015/16

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1 PURPOSE

1.1 To update the Committee on Treasury Management activity during 2015/16.

2 RECOMMENDATIONS

2.1 The Committee is asked to note the contents of the report.

3 BACKGROUND

3.1 The Council is required by regulations issued under the Local Government Scotland Act 2003 to produce an Annual Treasury Management Review.

3.2 The attached review updates members on the Treasury Management activity during 2015/16.

4 POLICY IMPLICATIONS

4.1 There are no direct policy implications associated with this report; however the Council's Treasury Management activity is determined by the policy framework set out in the approved Treasury Management Strategy.

5 INTEGRATED IMPACT ASSESSMENT

5.1 The subject of this report does not affect the wellbeing of the community or have a significant impact on equality, the environment or economy.

6 RESOURCE IMPLICATIONS

6.1 Financial – There are no direct financial implications associated with this report however the Council's Treasury Management activity clearly has a significant impact on the management of the Council's financial resources.

6.2 Personnel - none.

6.3 Other - none.

7 BACKGROUND PAPERS

7.1 Treasury Management Strategy 2015/16 to 2017/18 – East Lothian Council 24 February 2015.

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DATE	3 June 2016

Annual Treasury Management Review 2015/16

1. Introduction

This Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2015/16. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

During 2015/16 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 24/02/2015)
- a mid-year (minimum) treasury update report (Council 01/12/2015)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit and Governance Committee.

2. The Economy and Interest Rates

Market expectations for the first increase in Bank Rate moved considerably during 2015/16, starting at quarter 3 2015 but soon moving back to quarter 1 2016. However, by the end of the year, market expectations had moved back radically to quarter 2 2018 due to many fears including concerns that China's economic growth could be heading towards a hard landing; the potential destabilisation of some emerging market countries particularly exposed to the Chinese economic slowdown; and the continuation of the collapse in oil prices during 2015 together with continuing Eurozone growth uncertainties.

These concerns have caused sharp market volatility in equity prices during the year with corresponding impacts on bond prices and bond yields due to safe haven flows. Bank Rate, therefore, remained unchanged at 0.5% for the seventh successive year. Economic growth (GDP) in 2015/16 has been disappointing with growth falling steadily from an annual rate of 2.9% in quarter 1 2015 to 2.1% in quarter 4.

The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back. In addition, a notable trend in the year was that several central banks introduced negative interest rates as a measure to stimulate the creation of credit and hence economic growth.

The ECB commenced a full blown quantitative easing programme of purchases of Eurozone government and other bonds starting in March at €60bn per month. This put downward pressure on Eurozone bond yields. There was a further increase in this programme of QE in December 2015.

As for America, the economy has continued to grow healthily on the back of resilient consumer demand. The first increase in the central rate occurred in December 2015 since when there has been a return to caution as to the speed of further increases due to concerns around the risks to world growth.

The UK government has maintained its tight fiscal policy stance but the more recent downturn in expectations for economic growth has made it more difficult to return the public sector net borrowing to a balanced annual position within the period of this parliament.

3. Overall Treasury Position as at 31 March 2016

At the beginning and the end of 2015/16 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

TABLE 1	31 March 2015 Principal	Rate/ Return	Average Life yrs	31 March 2016 Principal		Rate/ Return	Average Life yrs
Total debt	***£335m***	***3.78%***	***17.2***		***£337m***	***4%***	***17.3***
CFR	***£368m***				***£384m***		
Over / (under) borrowing	***£(33)m***				***£(47)m***		
Total investments	***£6m***				***£10m***		
Net debt	**£335m**	**3.78%**			**£337m**	**4%**	

The Gross Capital Financing Requirement includes PFI and finance leases but as there are no capital borrowing requirements associated with these elements they are not included within the Treasury CFR. The Council Gross CFR at the31 March 2016 is £426m.

4. The Strategy for 2015/16

The expectation for interest rates within the treasury management strategy for 2015/16 anticipated low but rising Bank Rate, (starting in quarter 1 of 2016), and gradual rises in medium and longer term fixed borrowing rates during 2016/17. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

In this scenario, the treasury strategy was to minimise borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back.

5. The Borrowing Requirement and Debt

The Council's underlying need to borrow to finance **capital** expenditure is termed the Capital Financing Requirement (CFR).

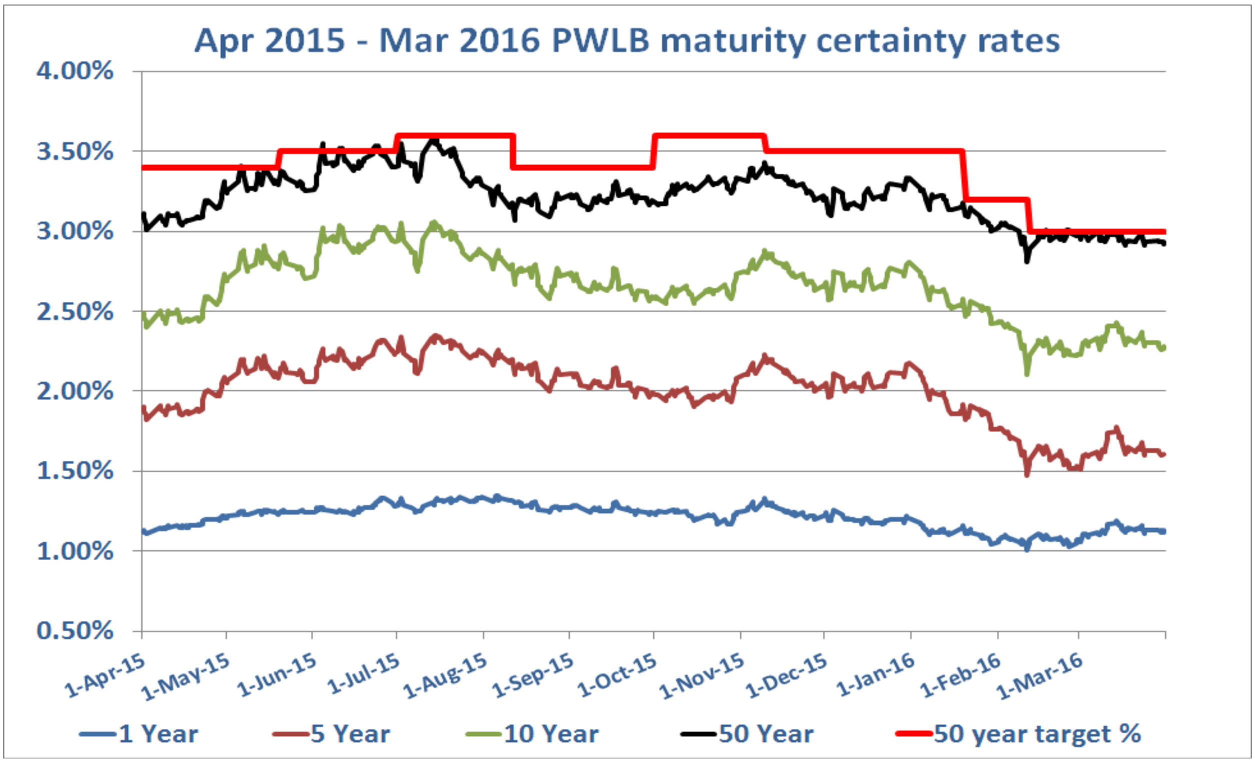
The General Fund CFR outturn saw an increase in CFR compared to budget of £2m. This comprises an increase in General Fund Capital Expenditure of £4m mainly due to the provision of a £3m loan to ELHA and £1m of additional capital spend. There was also a £2m increase in income compared to budget.

The HRA CFR has reduced by £6m and is attributable to an increase in income of over £2.4m as well as a reduction in capital spend of £3.5m

	31 March 2015 Actual	31 March 2016 Budget	31 March 2016 Actual
CFR General Fund (£m)	220	221	223
CFR HRA (£m)	148	167	161
Total CFR(£m)	368	388	384

6. Borrowing Rates in 2015/16

PWLB certainty maturity borrowing rates - the graph below shows how PWLB certainty rates have fallen to historically very low levels during the year.



7. Borrowing Outturn for 2015/16

Borrowing – the following loans were taken during the year: -

Lender	Principal	Type	Interest Rate	Maturity	Date
PWLB	£2.896m	Fixed interest rate	3.01%	48 years	03/09/15
PWLB	£3.5m	Fixed interest rate	2.94%	14 years	29/09/15
PWLB	£3.5m	Fixed interest rate	3.21%	44 Years	29/09/15
Stoke on Trent City Council	£6.5m	Fixed interest Rate	0.5%	3 Months	15/12/15
Kensington & Chelsea	£5m	Fixed interest rate	0.6%	6 Months	29/03/16

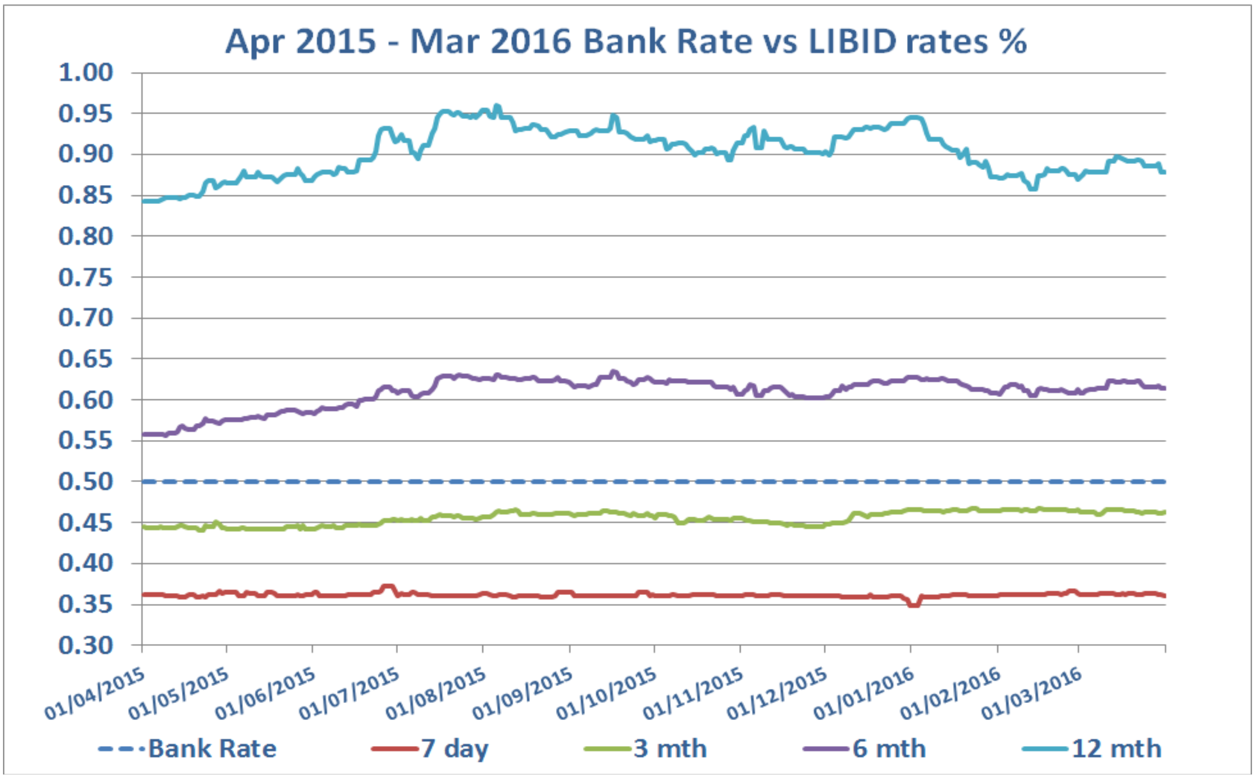
Repayment – the following loans were repaid during the year: -

Lender	Principal	Type	Interest Rate	Maturity	Date
PWLB	£6m	Fixed interest rate	3.12%	6 years	24/09/16
PWLB	£1.324m	Fixed interest rate	8.625%	21 years	08/10/15
Northamptonshire County Council	£3m	Fixed interest Rate	0.7%	1 Year	30/09/15
Stoke on Trent City Council	£6.5m	Fixed interest rate	0.5%	3 Months	15/03/16

Rescheduling

No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

8. Investment Rates in 2015/16



Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for seven years. Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 2016 but then moved back to around quarter 2 2018 by the end of the year. Deposit rates remained depressed during the whole of the year, primarily due to the effects of the Funding for Lending Scheme and due to the continuing weak expectations as to when Bank Rate would start rising.

9. Investment Outturn for 2015/16

Investment Policy – the Council's investment policy is governed by Scottish Government investment regulations which have been implemented in the annual investment strategy approved by the Council on 24/02/2015. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Investments held by the Council - the Council had minimal investment balances during the year as it sought to minimise its debt costs i.e. the Council temporarily used its reserves instead of external borrowing during 2015/16. It did, however, have the following loans to third parties which fall within the scope of the Councils Approved Investment Strategy:

Loan	Balance at 31/3/16
East Lothian Housing Association	£9.801m
East Lothian Investments	£0.010m
Haddington Golf Club	£0.002m

Investments held by fund managers – the Council uses Investec External Fund Managers to invest part cash balances held on behalf of the 4 Common Good funds and ELC Charitable Trusts . The performance of the managers against the benchmark return was:

Fund Manager	Investments Held 31 March 2015	Investments Held 31 March 16	Return	Benchmark*
Common Good	£3.053m	£2.849m	-3.1%	-0.7 %
Charitable Trust	£2.985m	£2.807m	-2.7%	-0.2. %
Total	£6.038m	£5.656m	-£0.382	

The return on the Common Good investment was -3.1% which was 0.7% less that the benchmark figure. The return on the Charitable Trust investment was -2.7% which was -2.5% less than the benchmark figure.

However for the same period the FTSE All Share produced a total return of -3.9%. The performance of the East Lothian portfolio and the Common Good was helped by holding defensive assets such as bonds and infrastructure but the Funds underperformed against their benchmark, having been hindered by a weak relative return at the start of 2016 when markets became fearful of a downturn in Chinese growth and of a further financial crisis. Against this background the discount on investment trust holdings widened and financial stocks fell back causing the bulk of the underperformance. Over the longer-term performance remains reasonable with the return over the last three years of 18.0% for the Council Charitable Fund and 17.7% for the Common Good Fund.

Appendix 1: Prudential and treasury indicators

Please choose which format you prefer between appendices 1 and 2.

1. PRUDENTIAL INDICATORS	2014/15	2015/16	2015/16
Extract from budget and rent setting report	**actual**	**original**	**actual**
	£'000	**£'000**	**£'000**
Capital Expenditure			
Non - HRA	£19,781	£27,380	£31,268
HRA (applies only to housing authorities)	£20,798	£25,450	£22,020
TOTAL	£40,579	£52,830	£53,288
Ratio of financing costs to net revenue stream			
Non - HRA	8.44%	8.62%	8.11%
HRA	30.42%	34.56%	33.21%
Borrowing requirement General Fund			
brought forward 1 April	£225,424	£219,841	£219,841
carried forward 31 March	£219,841	£220,637	£222,484
in year borrowing requirement	£(5,583)	£796	£2,643
Borrowing requirement HRA			
brought forward 1 April	£140,378	£148,354	£148,354
carried forward 31 March	£148,354	£167,159	£161,364
in year borrowing requirement	£7,976	£18,805	£13,010
Non – HRA	£219,841	£220,637	£222,484
HRA	£148,354	£167,159	£161,364
TOTAL	£368,195	£387,796	£383,848
Annual change in Cap. Financing Requirement			
Non – HRA	£(5,583)	£796	£2,643
HRA	£7,976	£18,805	£13,010
TOTAL	£2,393	£19,601	£15,653
Incremental impact of capital investment decisions	**£ p**	**£ p**	**£ p**
Increase in council tax (band D) per annum	£3.14	£8.16	£(3.59)
Increase in average housing rent per week	£2.61	£1.21	£2.33

2. TREASURY MANAGEMENT INDICATORS	2014/15	2015/16	2015/16
	actual	original	actual
	£'000	£'000	£'000
Authorised Limit for external debt -			
Borrowing	£433,000	£409,000	£409,000
other long term liabilities	£55,000	£52,000	£52,000
TOTAL	£488,000	£461,000	£461,000
Operational Boundary for external debt -			
borrowing	£403,259	£388,957	£388,957
other long term liabilities	£44,763	£42,490	£42,490
TOTAL	£448,022	£431,447	£431,447
Actual external debt	£334,930	£360,333	£337,160
Gross debt (includes PPP and Finance leases)	£386,508	£411,139	£387,976
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	100 %	100 %	100 %
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments	30 %	30 %	30 %
Upper limit for total principal sums invested for over 364 days	£30,000	£30,000	£30,000

Maturity structure of fixed rate borrowing during 2015/16	upper limit	lower limit
under 12 months	20%	0%
12 months and within 24 months	30%	0%
24 months and within 5 years	40%	0%
5 years and within 10 years	40%	0%
10 years and over	75%	0%